
July 2007

FEDERAL FAMILY EDUCATION LOAN PROGRAM

Increased Department of Education Oversight of Lender and School Activities Needed to Help Ensure Program Compliance





Highlights of GAO-07-750, a report to Congressional Requesters

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Increased Department of Education Oversight of Lender and School Activities Needed to Help Ensure Program Compliance

Why GAO Did This Study

Concerns have been raised about the Department of Education's (Education) role in overseeing the lenders and schools that participate in the largest of the federal government's student loan programs, the Federal Family Education Loan Program (FFELP). GAO was asked to analyze Education's use of its oversight, guidance, and enforcement authorities under FFELP. To do this, GAO reviewed departmental documents and federal laws, regulations, and cases and interviewed officials from Education and the student loan industry.

What GAO Recommends

GAO recommends that the Secretary of Education (1) update the department's oversight mechanisms to proactively identify possible instances of improper inducements and limitations on borrower choice, (2) be more proactive in investigating situations involving possible instances of these prohibited activities, (3) issue new guidance regarding inducements to guide the student loan industry until the relevant proposed regulations are finalized and become effective, and (4) develop a protocol to determine the appropriate level of response for cases of non-compliance and assess the effectiveness of these actions to inform and improve this protocol. Education agreed with the first two recommendations but did not explicitly agree or disagree with the other two.

www.gao.gov/cgi-bin/getrpt?GAO-07-750.

To view the full product, including the scope and methodology, click on the link above. For more information, contact George A. Scott at (202) 512-7215 or ScottG@gao.gov.

What GAO Found

While Education has some processes to oversee general compliance in FFELP, it has no oversight tools in place designed to proactively detect potential instances of lenders providing improper inducements—such as gifts to schools in exchange for preferred status on a school's suggested lender list—or schools limiting borrower choice of lender, two activities that are prohibited by law. Instead, the department primarily depends on external complaints to identify potential instances of non-compliance with these prohibitions. Historically, Education did not process these complaints in a systematic manner because complaint processing was not overseen by any one group. However, Education does have plans to conduct lender and school reviews to gather information on inducements, and it is considering updating its audit guides to begin detecting potential instances of improper inducements.

Education has not implemented formal comprehensive guidance on inducements since 1989, although it has repeated some of the information contained in that guidance in subsequent financial aid handbooks and other department publications. Instead, the department has responded informally to individual queries from the student loan community regarding allowable inducement practices. Education's Office of Inspector General recommended in 2003—and members of the student loan community have previously requested—that Education issue more guidance on these issues. In June 2007, Education issued proposed regulations that address improper inducements and limitations on borrower choice, and these regulations could become effective in July 2008 at the earliest.

Education has only attempted to use its sanctioning authority twice in the past 20 years to enforce prohibitions on improper inducements or limitations on borrower choice. In particular, Education disqualified one lender from FFELP for using misleading advertising and providing improper inducements to borrowers, and it initiated proceedings to limit the participation of another lender in light of what it had determined to be an improper inducement. When Education responds to non-compliance, the department instead has commonly sent letters to offending parties noting the prohibited activity and requesting they cease the activity. In addition, Education has not established a protocol for how to best respond to non-compliance—whether to write a letter requesting the activity to cease or to sanction a lender or school—nor has it routinely assessed the effectiveness of these actions in stopping prohibited activities.

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Abbreviations

DCL	Dear Colleague Letter
Education	Department of Education
FFELP	Federal Family Education Loan Program
FSA	Federal Student Aid
HEA	Higher Education Act of 1965
OIG	Office of Inspector General
OPE	Office of Postsecondary Education

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**United States Government Accountability Office
Washington, DC 20548**

July 31, 2007

The Honorable Edward M. Kennedy
Chairman
Committee on Health, Education, Labor, and Pensions
United States Senate

The Honorable George Miller
Chairman
Committee on Education and Labor
House of Representatives

The Honorable Richard J. Durbin
United States Senate

The Honorable Dale Kildee
House of Representatives

Concerns have been raised about the Department of Education's (Education) role in overseeing lenders and schools that participate in the largest of the federal government's student loan programs, the Federal Family Education Loan Program (FFELP), through which over \$46 billion in new student loans was disbursed in fiscal year 2006. Education is responsible for overseeing whether FFELP participants comply with federal laws and regulations that prohibit lenders from using inducements to increase loan volume¹ and that prohibit schools from limiting a borrower's choice of lender.²

To respond to your interest in this subject, we answered the following questions:

- To what extent has Education conducted oversight to help ensure compliance with prohibitions on improper inducements and limitations on borrower choice within FFELP?

¹20 U.S.C. § 1085(d)(5)(A).

²34 C.F.R. § 682.603(e)(3).

-
- To what extent has Education provided guidance to address concerns about improper inducements and limitations on borrower choice within FFELP?
 - To what extent has Education used its enforcement authority to help ensure compliance with prohibitions on improper inducements and limitations on borrower choice within FFELP?

On June 29, 2007, we briefed interested congressional staff on the results of our study, and this report formally conveys the information provided during this briefing. In general, we found that Education has no tools for proactively detecting potential instances of prohibited inducements and the limiting of borrower choice, although the department is considering revising some of its processes used to oversee general compliance with FFELP to begin detecting potential instances of these activities. Also, Education has been limited in its guidance and enforcement activity but has recently issued proposed regulations on inducements and borrower choice. More specifically, we found that:

- While Education has some processes in place to oversee general compliance with FFELP requirements, it has no oversight tools designed to proactively identify potential instances of prohibited inducements or limitations on borrower choice of lender. Instead, Education primarily depends on complaints to identify potential non-compliance. However, Education has begun to conduct lender and school reviews to gather information on inducements and is considering updating audit guides to begin detecting these prohibited lending activities.
- The department has not updated comprehensive guidance on inducements since 1989—despite requests for more guidance from the student loan community—but it has responded to individual queries regarding allowable practices. In June 2007, Education issued proposed regulations that could become effective in July 2008 at the earliest.
- As of June 2007, Education had either sanctioned or attempted to sanction a total of two lenders in the past 20 years. In particular, Education disqualified one lender from FFELP in 1988 and attempted to limit the participation of a second lender starting in 1995, both for offering prohibited inducements. More frequently, Education has written letters to offending parties when it responds to instances of non-compliance instead of imposing sanctions, but it has not routinely assessed the effectiveness of these letters.

In order to protect students and parents from paying unnecessarily high interest rates and fees because of improper lending activities among FFELP participants, we are recommending that the Secretary of Education update the department's oversight tools, more proactively investigate possible cases of program non-compliance, issue guidance on inducements, and develop a protocol to determine the appropriate level of response for cases of non-compliance and assess the effectiveness of its responses. In particular, we recommend that Education should:

- Update its oversight tools—such as financial audit and program review guidance—to identify possible instances of improper inducements and limitations on borrower choice.
- Be more proactive in examining situations involving possible improper inducements and limitations on borrower choice, such as exploring how schools generate preferred lender lists to determine if improper inducements have occurred.
- Issue new guidance—for example, through a Dear Colleague Letter (DCL)—regarding inducements to guide the industry until the relevant proposed regulations become effective in 2008 at the earliest.
- Establish a protocol for determining the level of response appropriate for different cases of non-compliance involving improper inducements or limitations on borrower choice—from writing letters to imposing fines to terminating participation—and assess the effectiveness of these actions to inform and improve this protocol.

We used the following methodology to develop our findings. To understand the framework of Education's oversight, guidance, and enforcement authorities, we reviewed relevant laws, regulations, and cases pertaining to prohibited inducements and limitations on borrower choice. To assess the extent of Education's oversight activities, we interviewed Education officials and reviewed departmental documents. Specifically, we reviewed and catalogued complaints received by Education and the department's responses to those complaints. We also reviewed the department's audit guides and its evaluations of program performance. To determine the extent to which Education provided guidance to the student loan community, we interviewed Education officials and student loan industry representatives. We also reviewed the department's various forms of guidance, including DCLs and individual letters to FFELP participants in response to their requests for guidance. To assess the extent of Education's enforcement activities, we interviewed

Education officials, reviewed departmental documents, and reviewed the case between Education and a lender pertaining to prohibited inducements. For additional information on our scope and methodology, please see appendix II. We conducted our work in accordance with generally accepted government auditing standards from February 2007 through June 2007.

We provided a draft copy of this report to the Department of Education for review and comment and also for technical review. In written comments on our draft report, Education concurred with our recommendations that the department update its oversight tools and that the department more proactively investigate possible cases of program non-compliance. Education also provided updates on its activities in these areas that we incorporated into this report, where appropriate.

With regard to our third recommendation that Education issue new guidance regarding inducements to guide the industry until the relevant proposed regulations are finalized and become effective, Education did not explicitly agree or disagree with the recommendation. Instead, Education noted that, as circumstances dictate, it may determine that specific guidance regarding inducements is appropriate. Education also stated that it will encourage schools and lenders to voluntarily implement the new regulations before they go into effect. Given that the proposed regulations will not become effective until July 1, 2008, at the earliest, we believe that Education should issue interim guidance on inducements to help ensure that schools and lenders comply with program requirements.

With regard to our fourth recommendation that Education develop a protocol to determine the appropriate level of response for incidents of non-compliance involving improper inducements or limitations of borrower choice and that Education routinely assess the effectiveness of its responses, Education again did not explicitly agree or disagree with the recommendation. Instead, Education discussed its review procedures to assess compliance with general FFELP regulations and noted its recent and ongoing updates to those procedures, points that were included in the draft copy of our report. Education added that these procedures include an explanation of which responses are appropriate for varying degrees of general non-compliance and stated that the procedures require FFELP participants to provide evidence of corrective action, and it noted that it will continue to review and enhance its existing protocols in these areas. Because routine and consistent follow-up in incidents of non-compliance involving improper inducements or limitations on borrower choice has not occurred, even with the updated review procedures, we continue to

believe that Education should develop a response protocol specific to improper inducements and limitations on borrower choice and to routinely assess the effectiveness of its responses.

Education's written comments appear in appendix III. We also incorporated Education's technical comments and other updates that the department provided on its activities, where appropriate.

We are sending copies of this report to relevant congressional committees, the Secretary of Education, and other interested parties. We will also make copies available to others upon request. In addition, this report will be available at no charge on GAO's Web site at www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-7215 or ScottG@gao.gov. Contact points for our Congressional Relations and Public Affairs offices may be found on the last page of this report. Other major contributors to this report are listed in appendix IV.



George A. Scott
Director, Education, Workforce,
and Income Security Issues

Appendix I: Briefing Slides



FEDERAL FAMILY EDUCATION LOAN PROGRAM:

Increased Department of Education Oversight of Lender and School Activities Needed to Help Ensure Program Compliance

**Briefing to Congressional Staff
June 29, 2007**



Overview

- Introduction
- Research Questions
- Scope and Methodology
- Summary of Key Findings
- Background
- Findings
- Conclusions
- Recommendations

Introduction



Investigations have revealed that some student loan lenders were paying schools to promote their loans, and some schools were limiting students' choice of lenders.

- Recent state, congressional, and other investigations have highlighted several improper lending practices with regard to student loans:
 - Lenders paying inducements or gifts to schools and financial aid officials in exchange for being placed on schools' "preferred lender" lists, which suggest particular financial institutions from which to borrow.
 - Schools otherwise limiting borrower choice of lender, such as by refusing to process loan applications.
- Inducements and limited borrower choice can hinder a borrower's ability to benefit from the competition among lenders that can result in such outcomes as lower interest rates and fee reimbursements.

Introduction



Concern has been raised about the Department of Education's oversight, guidance, and enforcement of the largest federal student loan program.

- The primary source of student loans for postsecondary education is the Federal Family Education Loan Program (FFELP).
 - In FY2006, \$46.2 billion in new student loans was disbursed for postsecondary education under FFELP.
- Under FFELP, lending institutions—such as banks and state or nonprofit agencies—provide loans to students, which are then guaranteed and, in some cases, subsidized by the federal government.
- Concern has been raised about the degree to which the Department of Education (Education) investigates questionable lending practices and enforces current federal prohibitions for federal student loans in FFELP.
 - In an effort to address concerns about the operation of the program, both the House and Senate are considering legislation that would address rules for lender and school participation in the program, as well as other program requirements.*

* Student Loan Sunshine Act, H.R. 890, and Higher Education Amendments of 2007, S. 1642. The House passed H.R. 890 on May 9, 2007, and the Senate passed S. 1642 on July 24, 2007.

Introduction



Existing federal laws prohibit lenders from providing inducements to increase loan volume and schools from limiting borrower choice within FFELP.

- Education is required to monitor FFELP participants to assess program compliance with federal laws that prohibit lenders from using inducements to increase loan volume and schools from limiting borrower choice of lender.
 - The Higher Education Act of 1965, as amended (HEA), prohibits lenders from offering “points, premiums, payments, or other inducements” to individuals or institutions “in order to secure applicants” for FFELP loans.* For example, Education has determined an inducement to be prohibited in a case where a lender provided a gift to a potential borrower contingent on the successful processing of that person’s loan.
 - Schools are prohibited from engaging “in any pattern or practice that results in a denial of the borrower’s access to FFEL loans because of the borrower’s...selection of a particular lender....”**

* 20 U.S.C. § 1085(d)(5)(A). This prohibition was added to the HEA in 1986.

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** 34 C.F.R. § 682.603(e)(3).

Research Questions



In response to a congressional request, GAO developed three research questions on Education's use of its authority under FFELP.

1. To what extent has Education conducted oversight to help ensure compliance with prohibitions on improper inducements and limitations on borrower choice within FFELP?
2. To what extent has Education provided guidance to address concerns about improper inducements and limitations on borrower choice within FFELP?
3. To what extent has Education used its enforcement authority to help ensure compliance with prohibitions on improper inducements and limitations on borrower choice within FFELP?

Scope and Methodology



To answer these questions, we interviewed Education and industry group staff and reviewed applicable federal laws and department documents.*

- To assess Education's oversight, guidance, and enforcement activities, we interviewed Education officials and student loan industry representatives, and we reviewed applicable federal laws and department documents, including:
 - Complaints and requests for guidance submitted by FFELP participants and Education's responses to them.
 - Education's audit guides and guidance.
- We conducted our work in accordance with generally accepted government auditing standards from February 2007 to June 2007.

* A detailed scope and methodology section is contained in appendix II.

Summary of Key Findings



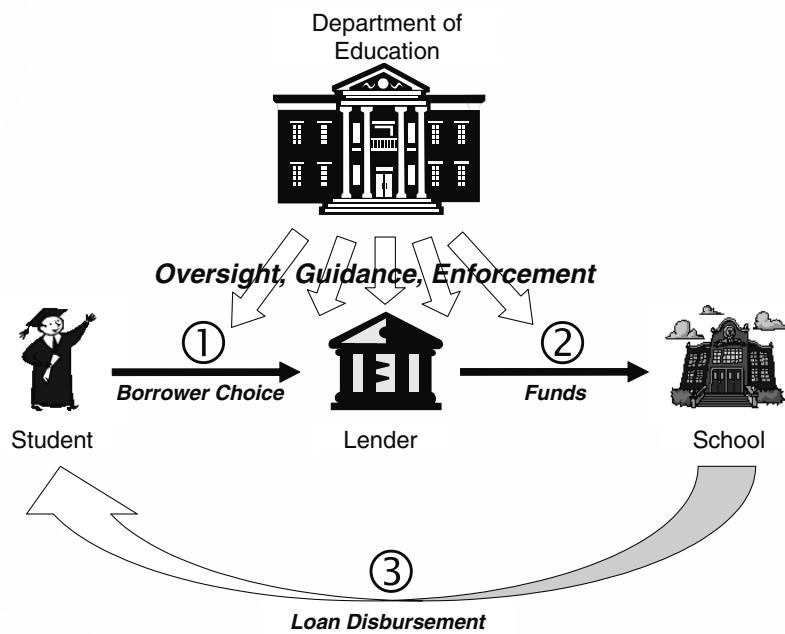
While Education has been limited in its oversight, guidance, and enforcement activities related to inducements and borrower choice, it is working to improve its oversight and offer guidance.

- While Education has some processes in place to oversee general compliance within FFELP, the department has not developed any oversight tools designed to proactively identify potential instances of improper inducements or limitations on borrower choice.
 - However, Education recently began reviewing schools and lenders identified by external investigators for potential use of inducements to assess the range of inducements offered.
 - Education is also considering updating its audit guides to better detect these prohibited lending activities.
- The department has not established comprehensive guidance on inducements since 1989, despite requests for more guidance.
 - In June 2007, the department issued proposed regulations regarding—among other things—prohibited inducements and preferred lender lists.
- The department has either sanctioned or attempted to sanction only two FFELP participants in the past 20 years for offering prohibited inducements.

Background – FFELP



Under FFELP, after a student selects a lender, the lender provides funds to the school, and the school disburses the loan.



Source: GAO analysis of FFELP structure and operation; icons provided by Art Explosion.

Note: Guaranty agencies provide insurance to lenders for at least 97% of the unpaid principal of defaulted loans disbursed on or after July 1, 2006. The federal government then reinsures the guaranty agencies.

Background – Private Educational Loans



Students may also use private educational loans, which Education is not responsible for overseeing.

Loan source	Borrower eligibility	Interest rates	Federal oversight responsibility for student lending activities
Federal Program*	Determined by financial need	<ul style="list-style-type: none">• Fixed**• Limited by statute***	<ul style="list-style-type: none">• Education
Private Lenders	Determined, in part, by credit history	<ul style="list-style-type: none">• Variable• Market-based• Frequently higher than FFELP interest rates	<ul style="list-style-type: none">• Various Banking Regulatory Agencies• Federal Trade Commission

* Federal student loans can be provided by lending institutions under FFELP or directly from the federal government through the William D. Ford Federal Direct Loan Program (FDLP). Schools can individually decide whether to participate in FFELP or FDLP, or both. The loan terms provided through the two programs are, by law, very similar.

** Interest rates are fixed for all FFELP loans disbursed on or after July 1, 2006. FFELP loans disbursed before July 1, 2006, have variable interest rates.

*** FFELP lenders can offer loans with interest rates and fees equal to or lower than what is specified by law.

Background – Oversight Authority



Education is required to monitor FFELP participants to assess program compliance.

- Education must ensure that FFELP lenders and schools undergo required financial and compliance audits.
 - The audits are performed to determine the extent to which lenders and schools comply with federal statutes and rules and regulations prescribed by the Secretary.
- Education is also required to perform program reviews of schools on a systematic basis.
 - These are used to assess schools' compliance with FFELP requirements and to assess school financial statements.

Background – Guidance Authority



Education can issue regulations and provide guidance.

- Education can issue regulations that prescribe rules with which program participants must comply.
- Education can also publish departmental guidance—for example, through Dear Colleague Letters (DCL)—that provide further information to program participants. DCLs can:
 - Provide operational guidance to participants in programs operated by Education.
 - Provide advice and insight into how Education will enforce statutory and regulatory provisions.
 - Serve as Education's interim interpretation of law when a law has gone into effect but the associated regulations have not yet been finalized.

Background – Enforcement Authority



In cases of program non-compliance, Education can employ sanctions.

- Education can impose civil penalties of up to \$27,500 for each prohibited practice by a lender and each instance of non-compliance by a school.*
 - To impose such penalties against a lender, Education must demonstrate, among other things, that the lender knew or should have known that its actions violated relevant federal laws or regulations regarding the program.
 - However, Education is not required to establish that a school knew or should have known that its actions violated federal laws or regulations in order to assess civil penalties against it.
- Education can limit, suspend, or terminate the participation of lenders and schools in FFELP.**

* For actions a lender has taken before being notified of its improper activities, Education can fine \$27,500 for its cumulative violations that occurred until the notification of non-compliance. However, if the lender takes corrective action before Education notifies the lender of non-compliance, Education cannot impose sanctions on the lender. See 20 U.S.C. § 1082(g) and 20 U.S.C. § 1094(c)(3)(B).

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** See 20 U.S.C. § 1082(h).

Background – Enforcement Authority



Education can also, in certain situations, take immediate emergency action to limit, suspend, or terminate the participation of lenders in FFELP.

- Education may also take emergency action against a lender when all of the following are met:
 - Reliable information is received regarding violations of applicable laws or regulations;
 - Education determines that immediate action is necessary to prevent the misuse of federal funds or substantial losses by borrowers; and
 - Education determines that the likelihood of financial loss by borrowers or the federal government exceeds the importance of following the procedures otherwise required to limit, suspend, or terminate the participation of a lender in FFELP.

* 20 U.S.C. § 1082(j) and 34 C.F.R. § 682.704.

Finding One (Oversight) – Overview



Education primarily uses complaints to identify non-compliance with prohibitions on inducements and limiting borrower choice.

- While Education has processes to oversee general compliance in FFELP, it has no oversight tools in place designed to proactively detect potential instances of improper inducements or limitations on borrower choice.
- Education primarily depends on external complaints to identify potential non-compliance. Until recently, Education did not process complaints in a systematic manner.
- Education is conducting lender and school reviews to gather information on inducements, and it is considering updating its audit guides to begin detecting potential instances of improper inducements.

Finding One (Oversight) – Processes in Place



Education conducts various oversight activities to monitor the general program compliance of FFELP participants.

- Education reviews annual financial and compliance audits of lenders and schools.
 - Lenders and schools hire independent contractors to conduct these audits.
 - Audits include assessing whether lenders charged the correct interest rate to borrowers and whether lenders maintain accurate and complete records of loans.
- Education is required to perform program reviews of schools on a systematic basis to assess their compliance with FFELP and other requirements.
 - For example, Education staff analyze school data to identify outliers or potential weaknesses in a school's administration of Education funds.

Finding One (Oversight) – Processes in Place



Education's oversight tools cannot proactively detect potential instances of improper inducements or limitations on borrower choice.

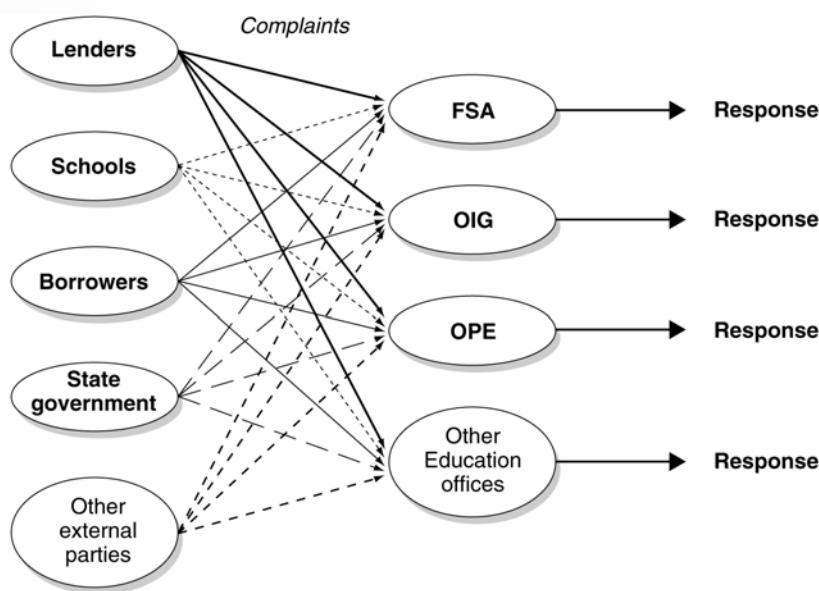
- Education's process for reviewing lender and school financial and compliance audits and conducting program reviews of schools does not include measures to detect potential instances of improper inducements or limitations on borrower choice.
- Education searches audit and program review data for anomalies, but can only verify improper inducements or limitations on borrower choice with further investigation.
 - For example, Education plans to write letters to schools where evidence suggests that borrower choice may be limited. However, further examination of these schools is not currently planned.*
- In addition, Education's Inspector General identified weaknesses in some of the tools to oversee lenders in September 2006.
 - For example, Education did not have processes for reviewing the quality or effectiveness of program reviews.

* On June 29, 2007, Education sent letters and e-mails to 921 schools that had at least 80 percent of their FFELP loan volume for the 2006-2007 academic year disbursed by a single lender. The correspondences reminded the schools of a borrower's right to choose any eligible lender and included a copy of the March 2007 DCL on this subject. Education also plans to send letters to associated lenders to remind them of applicable rules and regulations.

Finding One (Oversight) – Complaints



Before October 2006, Education primarily detected inducements and limitations of borrower choice from external complaints processed through multiple offices.



Source: GAO analysis of Department of Education structures and processes.

Acronyms: FSA Federal Student Aid (processes federal student aid and enforces rules and regulations)
OIG Office of Inspector General (conducts independent audits of Education's programs)
OPE Office of Postsecondary Education (develops federal policy and legislative proposals)

Finding One (Oversight) – Complaints



Complaints to Education have primarily focused on practices used by lenders and schools.

- Lender inducements to potential borrowers.
 - For example, \$300 gift cards to borrowers for taking out a loan from a particular lender.
- Lender inducements to schools.
 - For example, gifts received by a financial aid administrator.
- School restrictions of borrower choice of lender.
 - For example, a school preventing a student from borrowing from the lender of their choice by refusing to process the loan.

Finding One (Oversight) – Complaints



Education's process for documenting complaints has not been systematic until recently.

- The number and nature of all complaints made before October 2006 are unknown, since complaint processing was not overseen by any one group, and Education did not record all complaints and document its responses.
- Education reviewed 26 complaints between 2001 and 2006.
 - Twenty-two were submitted by a lender that originally submitted 600 complaints. Education narrowed the number of complaints to review by performing data analysis on the schools named.
- We found that Education's documentation demonstrates:
 - Determinations of compliance for 10 parties.
 - Determinations of non-compliance for 2 parties – Education issued a letter to each party asking them to cease prohibited activities.
 - No determination on compliance for the remaining 14 parties.
- Education officials stated that many complaints do not contain enough information—such as the names of the accused parties—to initiate a review.

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Finding One (Oversight) – Complaints



Education's complaint-driven approach does not identify all cases of improper inducements and limitations on borrower choice.

- State and congressional investigations identified improper arrangements between lenders and schools that Education had not yet investigated.
 - For example, a financial aid administrator at one university was found to have a financial interest in one of the school's preferred lenders. The administrator owned stock in the FFELP lender's parent company and profited more than \$100,000 from the sale of the stock.
 - For example, a director of student financial aid at another university was found to have negotiated with a FFELP lender to place the lender on the school's preferred lender list in return for benefits to the director and his staff, such as events and meals paid for by the lender.
 - For example, one FFELP lender paid more than \$70,000 for a cruise for select financial aid officers attending a financial aid conference.

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Finding One (Oversight) – Complaints



Education recently formed an inducement workgroup to review complaints.

- A Prohibited Inducement Workgroup comprised of multiple Education offices was formed in October 2006 to review complaints and inquiries related to improper inducements and to track the nature of concerns systematically.
- The Workgroup meets twice a month, logs new complaints, directs them to the relevant office, and monitors follow-up activity.
- The Workgroup had reviewed 21 cases and issued 2 letters to lenders reminding them of the prohibitions on improper inducements and limitation of borrower choice, as of June 18, 2007.* The other cases either have been closed or are still currently under review.

* These cases do not overlap with the complaints discussed on slide 20.

Finding One (Oversight) – New Processes



As of June 1, 2007, Education had conducted 2 reviews and had plans to conduct at least another 68 reviews to gather information on inducements.

- In April 2007, Education selected 44 schools and 26 lenders for reviews.* They include:
 - All schools and lenders named in the media as being under suspicion by the New York Attorney General's Office.
 - Schools with a large proportion of their students borrowing from the same lender.
- As of June 1, 2007, site visits for 2 reviews had been performed and will serve as pilots for future reviews.** Education will later determine how many of its remaining reviews will involve site visits.
- According to Education officials, the reviews contain two stages:
 - Staff collect information to learn more about the use of inducements.
 - If non-compliance is found, staff may issue sanctions in some of these cases. However, it is unclear what criteria Education will use to determine the need for sanctions.

* As of July 23, 2007, Education had selected another 3 schools and 1 lender to review.

** As of July 23, 2007, Education had conducted site visits for another 3 reviews, yielding a total of 5 completed site visits.

Finding One (Oversight) – New Processes



Education is considering updating its audit guides to begin detecting potential inducements.

- Education staff are considering updating the department's current audit review processes to include measures to detect possible improper inducements.
 - For example, Education staff are considering including reviews of agreements between schools and lenders in the audit guides. However, no timeline has been set for revising these audit guides.

Finding Two (Guidance) – Overview



Despite requests, Education has not implemented comprehensive guidance on inducements in almost 20 years.

- The department has not updated formal comprehensive guidance on inducements since 1989, but it issued proposed regulations in June 2007 that could be effective in July 2008 at the earliest.
- Education has responded informally to individual queries from the student loan community regarding allowable practices.
- The department's Inspector General recommended in 2003—and members of the student loan community we interviewed have previously requested—that Education issue more guidance.

Finding Two (Guidance) – Formal Guidance



The most recent comprehensive guidance on inducements was implemented in 1989, but updated guidance on borrower choice was published in 2007.

- Inducements – A 1989 DCL described allowable and improper activities and included examples of improper lending activities.
 - However, the letter is not available on Education's Web site.
 - A 1995 DCL and Education's annual Student Financial Aid Handbooks do not provide examples of improper activities and restate much of the same information as the 1989 letter.
- Borrower Choice – Education published DCLs in 1990, 1991, and 2007 related to school responsibilities regarding loan processing and a student's choice to borrow from any eligible lender.
 - This information was also presented at fall 2006 Federal Student Aid Conferences.

Finding Two (Guidance) – Formal Guidance



Education has issued proposed regulations on inducements and issues related to limitations on borrower choice.

- The Secretary of Education issued proposed regulations on prohibited inducements and preferred lender lists in June 2007, and these regulations will become effective July 1, 2008, at the earliest.*
 - The proposed regulations include a list of examples of prohibited inducements and activities and a list of all permissible activities.
 - They also specify the requirements schools must meet if they choose to provide preferred lender lists.
 - Education officials told us that they plan to issue the final regulations by November 1, 2007. If the department meets this goal, the final rule would take effect on July 1, 2008.**

* 72 Fed. Reg. 32, 410 (June 12, 2007) (to be codified at pt. 682).

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** 20 U.S.C. § 1089(c)(1).

Finding Two (Guidance) – Inquiries



Since 1990, Education has received at least 58 inquiries from schools, lenders, industry groups, and others about whether certain activities are permissible.

- Queries asked whether proposed inducements were permitted and included such things as the advertising and provision of benefits to potential borrowers and schools. Of 58 inquiries, Education identified improper activities more than 1/3 of the time.
 - The department primarily responded in writing to the inquiring party, but did not make its response publicly available.
 - Education's documentation does not demonstrate that a determination was made for at least 9 inquiries.
 - These 58 do not include other requests to Education that were not submitted in writing or that Education did not document.
- Some issues were raised in multiple queries, such as the prohibited provision of a gift to a potential borrower in return for a completed loan application.
- Two industry group representatives said their members' inquiries to Education sometimes go unanswered.

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Finding Two (Guidance) – More Requested



Education's Inspector General recommended—and industry groups have requested—that Education issue more guidance on inducements.

- Education's Inspector General interviewed lenders and industry groups as part of a 2003 investigation and concluded that the department should be more proactive in issuing guidance.
- Despite industry's attempt to self-regulate by issuing guidance and voluntary codes of conduct, student loan industry group officials we interviewed said that more guidance is needed from Education.
 - Members of the student loan industry repeatedly seek advice from industry groups, their own lawyers, and Education on allowable activities.

Finding Three (Enforcement) – Overview



Education has rarely used sanctions to enforce prohibitions on improper inducements or limitations on borrower choice.

- The department has sanctioned one FFELP participant and has attempted to use its authority to sanction one other FFELP participant in the past 20 years.
 - Besides these two instances, Education has not imposed any sanctions against any FFELP participant based on improper inducements or limited borrower choice of lender.
- When it responds to instances of non-compliance, the department more commonly sends a letter to the offending party requesting that the activity cease.
 - Education has not routinely assessed the effectiveness of these letters.

Finding Three (Enforcement) – Sanction Attempts



Education has sanctioned one lender and attempted to limit the participation of another lender as a result of non-compliance.

- In 1988, Education disqualified one student loan lender from FFELP. That lender was found to be using misleading advertising and providing inducements to borrowers.
- In 1995, the department initiated proceedings to limit the participation of student loan lender Sallie Mae in light of what it had determined to be an improper inducement involving the Dr. William M. Scholl College of Medicine.
 - On appeal, the U.S. District Court for the District of Columbia held that there was no violation, in part, because the school rather than Sallie Mae was the originating lender.*

* *Student Loan Marketing Assoc. v. Riley*, 112 F. Supp. 2d 38 (D.D.C. 2000).

Finding Three (Enforcement) – Responses



Education has primarily used letters to respond to cases of non-compliance.

- When Education does respond to instances of non-compliance, the department has commonly sent letters to offending parties noting the prohibited activity and requesting they cease the activity, but has not imposed sanctions.* For example:
 - For two lenders that were found offering rebates to loan applicants, Education sent letters asking them to cease the activity and to return pending applications to applicants.
 - For one school that was denying its students the ability to take loans from a particular lender, Education sent a letter requesting that the school cease the activity.
 - Education plans to send a letter to lenders offering gift cards or music players to borrowers who complete loans with them.
- Education has not established a protocol for how to best respond to non-compliance—whether in a letter or with a sanction—nor has it routinely assessed the effectiveness of these actions in stopping prohibited activities.

* An official from Education's Office of General Counsel stated that the department does not consider the issuance of letters to lenders and schools an enforcement action.

Conclusions



Although Education has recently taken steps to improve its coordination across offices, it has continued to be reactive in its examination of questionable lending practices.

- Education's recent development of the Prohibited Inducement Workgroup could result in increased coordination across department offices in addressing improper inducements and limited borrower choice.
- However, to date, Education has been reactive in its oversight and examination of these prohibited lending practices. This has limited the ability of the department to identify and verify occurrences of program non-compliance.
 - For example, Education only pursues examination of possible instances of non-compliance after complaints are received.
 - It is unknown when audit guides will be updated to address these prohibited activities.

Conclusions



Education provided limited guidance updates until recently and does not have a formalized process for determining the need for sanctions.

- Education has taken limited actions to update its guidance on inducements, despite requests to Education for more guidance.
 - This has resulted in the student loan industry being the main contributor to defining industry best practices.
 - Until the new regulations are finalized and go into effect, the industry will continue to operate under outdated guidance.
- Education's limited enforcement efforts regarding prohibited inducements and limitations on borrower choice may have resulted in some students taking loans with higher interest rates or fewer borrower benefits.
 - The department has not established a process to determine the level of response appropriate for a given case of non-compliance.
 - The department has also not reviewed the effectiveness of its letters and sanctions to inform future enforcement decisions.

Recommendations



Education should be more proactive in its oversight activity to help ensure FFELP program compliance and to protect borrowers.

➤ Education should:

- Update its oversight tools—such as audit and program review guidance—to identify possible instances of improper inducements and limitations on borrower choice.
- Be more proactive in examining situations involving possible improper inducements and limitations on borrower choice, such as exploring how schools generate preferred lender lists to determine if improper inducements have occurred.

Recommendations



Education should be more proactive in its guidance and enforcement activity to help ensure FFELP program compliance and to protect borrowers.

➤ Education should:

- Issue new guidance—for example, through a DCL—regarding inducements to guide the industry until the relevant proposed regulations become effective in 2008 at the earliest.
- Establish a protocol for determining the level of response appropriate for different cases of non-compliance involving improper inducements or limitations on borrower choice—from writing letters to imposing fines to terminating participation—and assess the effectiveness of these actions to inform and improve this protocol.

Appendix II: Scope and Methodology

To understand the framework of Education's oversight, guidance, and enforcement authorities, we reviewed relevant laws, regulations, and cases pertaining to prohibited inducements and limitations on borrower choice of lender.

To assess the extent of Education's oversight activities, we interviewed Education officials and reviewed departmental documents. In particular, we interviewed officials from the Office of Postsecondary Education, Federal Student Aid, Ombudsman Office, and Office of the Inspector General. With regard to documentation, we reviewed and catalogued complaints received by Education and documentation of the department's responses to those complaints. However, the complaints we received from Education may not represent all complaints submitted to the department because, prior to October 2006, Education did not record all the complaints received or document its responses. We also reviewed the department's audit guides and its evaluations of program performance.

To determine the extent to which Education provided guidance to the student loan community, we interviewed Education officials and student loan industry representatives, and we reviewed departmental guidance. Within Education, we interviewed staff from the Office of Postsecondary Education, Federal Student Aid, Ombudsman Office, and Office of the Inspector General. Within the student loan industry, we interviewed representatives from the Consumer Bankers Association, Education Finance Council, National Council of Higher Education Loan Programs, and National Association of Student Financial Aid Administrators. We reviewed the department's various forms of guidance—including DCLs and individual letters to FFELP participants in response to their requests for guidance. We also documented Education's practices for making determinations concerning the alleged activity and catalogued the department's written responses to these concerns and inquiries. Education provided us all the requests for guidance made in writing since 1990 that it had on file. However, the requests we received from the department may not represent all requests submitted to the department for clarification since some could have been submitted by phone or not documented.

To assess the extent of Education's enforcement activities, we interviewed Education officials and reviewed departmental documents and applicable federal laws. Specifically, within Education, we interviewed staff from the Office of Postsecondary Education, Federal Student Aid, Ombudsman Office, and Office of the Inspector General to examine actions taken to address inducement and borrower choice issues. Furthermore, we reviewed information used by Education to make determinations

regarding alleged improper lending activities (e.g., lender marketing materials containing alleged inducements and lender inducements resulting in preferred placement on preferred lender lists). We also examined several Education offices' protocols for performing reviews in the context of program compliance.

We conducted our work in accordance with generally accepted government auditing standards from February 2007 through June 2007.

Appendix III: Comments from the Department of Education



CHIEF OPERATING OFFICER

Honorable David M. Walker
Comptroller General
Government Accountability Office
441 G Street, NW
Washington, DC 20548

JUL 20 2007

Dear Mr. Walker:

In accordance with 31 U.S.C. 720, I am writing to respond to recommendations made in the Government Accountability Office (GAO) report, "Federal Family Education Loan Program: Increased Department of Education Oversight of Lender and School Activities Needed to Help Ensure Program Compliance" (GAO-07-750). This report focused on two specific areas of lender and school oversight - improper inducements and the limitations on borrower choice of lender in the Federal Family Education Loan (FFEL) program.

We appreciate this opportunity to respond to the GAO report. We are aware of the current concerns regarding lenders providing improper inducements and schools limiting borrower choice of lender. However, under existing law, the Department's authority to take action regarding some of these practices is limited. For example, the law includes a quid pro quo requirement for lender inducement violations, and current regulations do not include any specific limitations on the use of the preferred lender lists by schools. Given these limitations, while the activity is suspect, it may or may not violate the law.

Background

In March 2006, the Department initiated a strategy to enhance its oversight of Title IV participants. To provide more efficient and effective oversight of Title IV participants, the Department's Federal Student Aid office consolidated all program compliance functions under one senior executive who reports directly to the Chief Operating Officer of Federal Student Aid. In August 2006, the Department began a negotiated rulemaking process to develop regulations to clarify and strengthen the regulations governing preferred lender list practices and improper inducements. After extensive negotiations with the student aid community, including representatives of lenders, guaranty agencies, and schools, a Notice of Proposed Rulemaking (NPRM) was published in the Federal Register on June 12, 2007. That NPRM included proposals that would significantly strengthen the rules regarding prohibited inducements and would specifically regulate the use of preferred lender lists. While final regulations resulting from the June 12, 2007, NPRM will not become effective until July 1, 2008, the Department has been conducting, and will continue to conduct, reviews of schools, lenders, and guaranty agencies to ensure compliance with current requirements.

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In October 2006, the Department established a workgroup to review compliance issues with the prohibited inducement provisions of the Higher Education Act (HEA). The purpose of the workgroup is to provide a centralized process for the review of inducement and borrower choice issues ensuring consistent and appropriate review and follow-up. In April 2007, the Secretary convened an intra-departmental taskforce to review the proposals that came out of the negotiated rulemaking process discussed earlier and to make recommendations for the NPRM. Finally, in June 2007, Federal Student Aid created a workgroup to review and update school and lender review procedures regarding compliance with the borrower choice and improper inducements provisions. We believe that this multi-faceted strategy should strengthen program integrity, improve Departmental oversight, and ensure participant compliance.

Response to Recommendations

The following addresses the recommendations in the report:

Recommendation 1. Update the Department's oversight mechanisms to proactively identify possible instances of improper inducements and limitations on borrower choice.

Action: We concur. In fact the Department has taken a number of steps to improve its processes and procedures for providing effective oversight of schools and lenders, including in the areas of improper inducements and limitations on borrower choice.

On a strategic level, as noted earlier, in March 2006, our Federal Student Aid office consolidated all business areas with functional responsibility for oversight and monitoring under one senior executive reporting directly to Federal Student Aid's Chief Operating Officer. In October 2006, Federal Student Aid established a workgroup to review compliance with the prohibited inducement provisions of the HEA. In April 2007, the Secretary's intra-departmental taskforce began to review and recommend proposed regulations that were ultimately included in the June 12, 2007, NPRM. Those regulations, when finalized and effective, will require more disclosures of the arrangements between schools and lenders and schools and guaranty agencies. Finally, in June 2007, Federal Student Aid created a workgroup to review and update school and lender compliance procedures around borrower choice and improper inducements.

On a tactical level, in April 2007, we developed procedures to support reviews of both lender inducement and limitations on borrower choice and will incorporate those procedures into our general review process. We also made recommendations to the Department's Office of the Inspector General to include in the audit guides procedures for examining whether improper inducements or limitations on borrower choice exist. Finally, we notified guaranty agencies to incorporate improper inducement procedures in their lender reviews.

Recommendation 2. Be more proactive in investigating situations involving possible instances of these prohibited activities.

Action: We concur and as such are implementing new processes and procedures. In October 2006, as a result of complaints about restrictions on borrower choice, Federal Student Aid initiated borrower choice reviews at targeted schools. For example, we initiated

program reviews at 11 institutions that allegedly were refusing to process loan applications submitted by students for a specific lender. Those reviews concluded with the one institution where evidence of such a denial was obtained being cited for the violation. The presidents of the remaining ten institutions received a letter reminding them of the regulatory requirements. Additionally, in April 2007, we initiated focused inducement and borrower choice reviews at targeted schools and lenders. These reviews are ongoing.

In June 2007, we identified 921 schools that had at least 80% of their FFEL loan volume for the 2006-2007 academic year with a single lender. Although the fact that these schools had at least 80% of their loans with one lender does not necessarily mean there is a violation, we sent a letter to these schools reminding them of a borrower's right to use a lender of his or her choice. This letter was a follow-up to a March 29, 2007, "Dear Colleague" letter on this subject. This was part of our ongoing efforts to ensure strict compliance and oversight of all our programs. We reminded these schools that the Department will impose fines or take other administrative actions for violating any statutory and regulatory requirements. Recently, we posted another letter to our Web site reminding all schools of the requirements.

We will contact lenders to ensure their compliance with applicable rules and regulations.

Recommendation 3: Issue new guidance regarding inducements to guide the student loan industry until the relevant proposed regulations are finalized and become effective.

Action: As noted earlier, the NPRM published on June 12, 2007 would significantly strengthen and clarify the rules related to prohibited inducements and would, for the first time, regulate the use of preferred lender lists by schools. As circumstances dictate, we may determine that specific guidance regarding inducements is appropriate. As soon as the new regulations are finalized, we will continue our efforts to ensure that all parties (lenders, guaranty agencies, schools) are aware of the new requirements and how they are to be implemented and enforced. Also, when we publish (no later than November 1, 2007) the final rules on prohibited inducements and preferred lender lists, we will strongly recommend that schools and lenders voluntarily implement the new rules prior to their official effective date of July 1, 2008, as is provided in section 482(c)(2) of the HEA.

Recommendation 4: Develop a protocol to determine the appropriate level of response for cases of non-compliance and assess the effectiveness of these actions to inform and improve this protocol.

Action: The Department is currently updating procedures for lender and guaranty agency oversight. In September 2006, we updated our school review procedures. These procedures are comprehensive and ensure standardization and consistency in school oversight. The procedures include appropriate actions for various compliance findings, including possible administrative actions, i.e., fines, limitations, suspensions and terminations.

As part of our current review procedures, schools, lenders, and guaranty agencies are required to submit evidence that any non-compliance was corrected or to establish a corrective action plan, which we then verify. For example, the school cited for non-compliance in the October 2006 targeted review submitted a corrective action plan to the

**Appendix III: Comments from the Department
of Education**

Department. We then verified the corrective action by reviewing the school's revisions to its Web site clarifying "borrower choice."

The Department will continue to review and enhance our existing protocols for determining the appropriate level of response for cases of non-compliance.

In addition to these responses to the report's recommendations, we are including, as an attachment to this letter, clarifications we propose to the briefing slides contained in Appendix I of the report.

I appreciate the opportunity to respond to the GAO report. If you or your staff have any questions regarding our responses, please contact me or Marge White of my staff at (202) 377-3022.

Sincerely,



Lawrence A. Warder

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

George Scott, Director, at (202) 512-7215 or ScottG@gao.gov.

Staff Acknowledgments

Melissa Emrey-Arras, Assistant Director, and Jeffrey W. Weinstein, Analyst-in-Charge, managed this assignment. Other staff members who made key contributions to the assignment include Summer Pachman, Kenrick Isaac, Debra Prescott, Charlie Willson, Ramona Burton, and Lorin Obler. Sheila McCoy, Doreen S. Feldman, and Richard Burkard provided legal assistance. Luann Moy assisted with methodology. Karen Burke provided assistance with graphics and layout.

Related GAO Products

Federal Family Education Loan Program: More Oversight Is Needed for Schools That Are Lenders. [GAO-05-184](#). Washington, D.C.: January 2005.

Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure. [GAO-05-61](#). Washington, D.C.: October 2004.

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Department of Education: Guaranteed Student Loan Program Vulnerabilities. [GAO-03-268R](#). Washington, D.C.: November 2002.

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